

FX Daily: Multiple factors still at play in FX

Equity selloffs, US election bets, and carry trade unwinding have contributed to a heterogeneous picture in the currency market. US data has been, to a certain extent, sidelined. Today's June core PCE may trigger only a modestly negative USD reaction. USD/JPY could suffer larger losses again soon



USD: Oversupply of FX drivers

The [US GDP report](#) for the second quarter came in stronger than expected yesterday. Growth was a solid 2.8% and core PCE slowed from 3.7% to 2.9%, above the 2.7% consensus. As noted by our US economist, that implies that the June PCE deflator will be 0.28% MoM today, which seems unlikely based off the inputs from CPI and PPI. So we suspect it will also involve upward revisions to the previous couple of months. The consensus is for 0.2% MoM.

A stronger GDP/PCE would have sent shockwaves across the FX markets and boosted the dollar in other market conditions. But yesterday's reaction consisted only of a short-lived and modest dollar rally. We think there are two reasons for that.

First, US macro is not currently the main FX driver, or at least there is an unusual abundance of drivers. The fallout of the tech sell-off, frontloaded US election positioning, and the unwinding of

carry trades have generated moves large enough in magnitude to out shadow US data.

Second, markets have made a conviction call on Fed easing, and yesterday's figures did not cast serious doubts on the disinflationary path. Even if that path may turn out shallower than expected, it's understandably deemed consistent with monetary easing should the jobs market also continue to loosen.

The most watched pair in FX – USD/JPY – caught a breather yesterday, now stabilising slightly below 154.0. However, the size of JPY short positions and the risk-off mood in the market mean there is probably more room for a rebound in the yen before this adjustment can be complete. In our view, markets are also underestimating the chances of a 15bp Bank of Japan hike next week. Tokyo consumer price data showed that headline inflation edged down to 2.2% YoY in July (vs 2.3% in June, market consensus), but the BoJ's preferred measure, core inflation excluding fresh food, rose to 2.2% in July (vs 2.1% in June, 2.2% market consensus). We believe that inflationary pressure in services continues to build. It is a close call, but we maintain our view that the BoJ will hike rates by 15bp and reduce its bond-buying programme at the same time.

The DXY dollar index is benefitting from the low volatility of the euro and remains an inaccurate benchmark of current dollar conditions. Today, a core PCE at 0.2% MoM could anyway help it trade again on the soft side and re-test 104.0.

One theme to follow ahead of the US election is Donald Trump's "complicated" relationship with the dollar. Chris Turner discusses [here](#) whether the US does indeed have a strong dollar issue, as Trump suggests.

Francesco Pesole

➔ EUR: Grim surveys can be overlooked, for now

In just three months, activity surveys in Germany went from showing slower momentum to effectively arguing against any optimism on the economic outlook. This was the case for the [July IFO](#), published yesterday, which fell markedly. The theme of Germany being the sick man of Europe is understandably re-gaining traction, but what does it mean for the euro?

In the medium run, it probably suggests the steadily declining fair value of EUR/USD will remain depressed, hindering the kind of multi-quarter appreciation that would be consistent with other valuation metrics, like PPP. In the near term, it may not matter that much. Markets made their call on two ECB cuts some time ago, and a worsening growth picture is not enough to drive bets on three cuts as long as wages and inflation prove sticky.

Today, we'll be looking at the ECB inflation expectations surveys. With even hawks like Joachim Nagel implicitly endorsing market pricing by saying the ECB should be able to cut if data stays on course, major swings in ECB pricing appear unlikely.

EUR/USD remains stable amid wide moves in G10 FX. We suspect this is down to the euro's liquidity attractiveness, and we doubt we'll see a break from the ranges today, with 1.0850 still working as a near-term anchor.

Francesco Pesole

➔ GBP: EUR/GBP rally can accelerate next week

Earlier this week, we [stressed](#) how GBP/USD looked expensive at 1.29 and EUR/GBP looked cheap at 0.84. We are, therefore, welcoming the downside and upside moves (respectively) of the past two days as a re-alignment with short-term rate differentials.

We think both those moves can have long legs as we expect a broad-based GBP weakening next week when the Bank of England will – in our view – cut rates. Our reasoning is detailed in this article by our UK economist, but in short, we think the BoE will judge the stickiness in services inflation as down primarily to one-off factors and may look at more “core” measures that instead point to a less worrying picture. Market pricing (-13bp) suggests there is room for a GBP correction.

Francesco Pesole

➔ CEE: Global rally improves FX picture in region

The end of the week in the region is similar to the previous days with little of note in the calendar but a busy FX market. Thanks to yesterday's rally in the core markets, the CEE picture has improved materially on a relative basis, which has halted the sell-off in HUF for now, but we saw gains across the region yesterday as well. So EUR/HUF could take a breather and stabilize for a while if HUF rates don't follow the core market today. However, we remain on the bearish side with more fair levels at 394 and higher.

EUR/CZK, on the other hand, with yesterday's continued paying flow and higher EUR/USD opens the door to 25.200 ahead of next week's CNB meeting.

EUR/PLN has little to direct it. Within the 4.270-300 range, it has bounced off the top and is back to 4.285. We expect more volatility here next week with July inflation. A Bloomberg survey already suggests a wide range from 4.0% to 4.8%. Our economists are going for 4.5% YoY.

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